

ORIGINAL



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MEMORANDUM

30

TO: Docket Control

FROM: Ernest G. Johnson ✓
Director
Utilities Division

DATE: October 31, 2006

RE: STAFF REPORT FOR THE TUCSON ELECTRIC POWER COMPANY
APPLICATION FOR A FINANCING ORDER AUTHORIZING
AMENDMENTS TO OR REFINANCING OF ITS CREDIT AGREEMENT.
(DOCKET NO. E-01933A-06-0345)

Attached is the Staff Report for Tucson Electric Power Company's application for a financing order authorizing amendments to or refinancing of its credit agreement. Staff recommends approval of the proposed financing.

Any party who wishes may file comments to the Staff Report with the Commission's Docket Control by 4:00 p.m. on or before November 13, 2006.

EGJ:PMC:red

Originator: Pedro M. Chaves

Attachment: Original and fourteen copies

Arizona Corporation Commission
DOCKETED

OCT 31 2006

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Docket No. E-01933A-06-0345

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

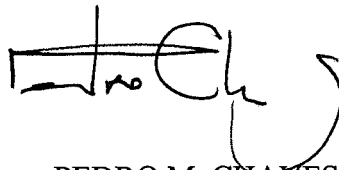
**TUCSON ELECTRIC POWER COMPANY
DOCKET NO. E-01933A-06-0345**

APPLICATION FOR FINANCING

OCTOBER 31, 2006

STAFF ACKNOWLEDGMENT

The Staff Report for Tucson Electric Power Company, Docket No. E-01933A-06-0345 is the responsibility of the Staff members listed below: Pedro M. Chaves is responsible for the review and financial analysis of the Company's application.

A handwritten signature in black ink, appearing to read 'Pedro M. Chaves', with a stylized flourish at the end.

PEDRO M. CHAVES
PUBLIC UTILITIES ANALYST II

EXECUTIVE SUMMARY
TUCSON ELECTRIC POWER COMPANY
DOCKET NO. E-01933A-06-0345

Tucson Electric Power Company ("TEP", "Applicant" or "Company") is a wholly owned subsidiary of Unisource Energy Corporation, and a for-profit Class "A" Arizona public service corporation that serves approximately 385,000 customers and is located in Tucson, Arizona.

TEP filed an application with the Arizona Corporation Commission ("Commission") on May 25, 2006, requesting authorization to amend or refinance its credit agreement.

TEP currently has a \$60 million revolving credit facility and a \$341 million letter of credit ("LOC") facility. Both of these credit facilities mature on May 4, 2010. The revolving credit facility is used for short-term liquidity and working capital purposes. The LOC facility is used to support a \$329 million aggregate principal amount of tax-exempt variable-rate debt obligations and up to \$12 million in accrued interest obligations.

TEP requests an order authorizing it to extend the maturity of the revolving credit and LOC facilities. TEP also requests authorization to increase the amount of the revolving credit facility from \$60 million to \$150 million. In addition, the Company requests authorization to refinance the credit facilities during the subsequent three-year period should favorable opportunities arise.

TEP's existing capital structure consists of 2.3 percent short-term debt, 71.0 percent long-term debt, and 26.7 percent equity. Staff's pro forma capital structure is composed of 8.9 percent short-term debt, 66.2 percent long-term debt and 24.9 percent equity.

Staff calculated a 1.43 times interest earned ratio ("TIER"), a 2.03 debt service coverage ratio ("DSC"), a 2.65 cash coverage ("CCR") and a 4.14 leverage test ratio for the Applicant for the fiscal year ended in 2005. Staff's pro forma TIER, DSC, CCR and leverage test ratio resulting from the requested increase of the revolving credit facility are 1.34, 1.08, 2.49 and 4.55 respectively. The pro forma DSC results indicate that operating cash flow would be sufficient to cover all obligations.

Staff concludes that the proposed financing for the purposes stated in the application is within TEP's corporate powers, is compatible with the public interest, consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize TEP's request to increase the amount of the revolving credit facility from \$60 million to \$150 million.

Staff further recommends that the Commission authorize TEP's request to refinance the credit facilities during the subsequent three-year period, pursuant to the Applicant's suggested restrictions as described in the application.

TABLE OF CONTENTS

	<u>PAGE</u>
INTRODUCTION	1
PUBLIC NOTICE.....	1
BACKGROUND	1
DESCRIPTION OF PROPOSED FINANCING.....	2
REVOLVING CREDIT AND LOC FACILITIES MATURITY EXTENSION.....	2
REVOLVING CREDIT FACILITY INCREASE	2
SUBSEQUENT AMENDMENTS OR REFINANCINGS.....	3
FINANCIAL ANALYSIS.....	3
TIER, DSC, CCR AND LEVERAGE TEST RATIO.....	4
CAPITAL STRUCTURE.....	4
COMPLIANCE.....	5
CONCLUSION AND RECOMMENDATIONS.....	5

SCHEDULES

Financial Analysis.....	PMC-1
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Attachments

Notice

Introduction

On May 25, 2006, Tucson Electric Power Company ("TEP" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission") requesting authorization to amend or refinance its credit agreement dated May 4, 2005 ("2005 Credit Agreement").¹

TEP's 2005 Credit Agreement consists of a \$60 million revolving credit facility and a \$341 million letter of credit ("LOC") facility. Both credit facilities mature on May 4, 2010, and are collateralized by mortgage bonds issued under TEP's 1992 mortgage.

The revolving credit facility is used for short-term liquidity and working capital purposes. The LOC facility is used to support a \$329 million aggregate principal amount of tax-exempt variable-rate debt obligations and up to \$12 million in accrued interest obligations. The Credit facilities are currently rated investment grade, BBB- by Standard and Poors ("S&P") and Baa3 by Moody's Investor Services ("Moody's").

Public Notice

On October 6, 2006, the Applicant filed an affidavit of publication verifying public notice of its financing application. The Applicant published notice of its financing application in the *Daily Territorial* on July 18, 2006, and in the *Arizona Daily Star* on July 19, 2006. The *Daily Territorial* is a daily newspaper printed and published in the County of Pima, Arizona, and of general circulation in the City of Tucson. The *Arizona Daily Star* is a daily newspaper printed, published, and of general circulation in the City of Tucson, Pima County, Arizona. The affidavit of publication is attached along with a copy of the Notice.

Background

TEP is a wholly owned subsidiary of Unisource Energy Corporation, and a for-profit Class "A" Arizona public service corporation located in Tucson, Arizona. TEP provides generation, transmission and distribution services to approximately 385,000 retail customers in Tucson, the surrounding Pima County area and to Fort Huachuca in Cochise County.

The Federal Energy Regulatory Commission ("FERC") and the Commission regulate portions of TEP's utility accounting practices and electricity rates. The Commission has authority over TEP's rates charged to retail customers, the issuance of securities, and transactions with affiliated parties.²

¹ Pursuant to Decision No. 66174, dated August 13, 2003, TEP refinanced its credit facilities twice during the two year period (first in March 2004, and then in May 2005) resulting in the 2005 Credit Agreement.

² TEP's annual report for the fiscal year ended December 31, 2005, page K-9.

TEP's current retail rates were established under a settlement agreement authorized in Decision No. 62103, dated November 30, 1999. Under the settlement agreement, TEP's rates are capped until December 31, 2008.³

Description of Proposed Financing

The Applicant asks approval of the Commission to: (1) extend the maturity of the revolving credit and LOC facilities, (2) increase the amount of the revolving credit facility from \$60 million to \$150 million and (3) enter into similar amendments or refinancings to extend the credit facilities during the subsequent three-year period, should favorable opportunities arise.⁴

Revolving Credit and LOC Facilities Maturity Extension

Borrowings under the revolving credit and the LOC facilities bear interest at a variable interest rate over the London Interbank Offered Rate ("LIBOR") or an Alternate Base Rate ("ABR"). As of June 30, 2006, the applicable borrowing rate is LIBOR plus 0.875 percent. The Applicant also pays a commitment fee of 0.20 percent on the unused portion of the revolving credit facility and a LOC fronting fee of 0.25 percent to the two banks that are the issuers of the LOC.

TEP expects to receive lower fees and interest rates on its credit facilities due to favorable changes in the bank credit markets. The Applicant points out that extending the term of the credit facilities would reduce refinancing risk and lock in lower rates and fees for the extended term. Specifically, TEP expects the new LOC fee and interest rate spread on borrowings to be approximately 17.5 basis points lower than the existing fee and interest rate spread. TEP expects a 7.5 basis points decrease on its revolving credit facility commitment fee. The Applicant expects the total annual savings on these reductions to be approximate \$625,000.⁵

Revolving Credit Facility Increase

The Applicant cites that an increase of the amount of the revolving credit facility would: (1) increase its access to funds for short-term liquidity and working capital, (2) fund on a short-term basis, its growing level of capital expenditures and (3) be viewed positively by the ratings agencies.

An increase in the amount of the revolving credit facility would require an increase of a similar amount to mortgage bonds issued as collateral. TEP expects to issue a new series of mortgage bonds in the total amount of the facilities (a total of \$490,600,000). The Applicant expects the new series of mortgage bonds to have an interest rate of ABR + 3 percent, maturing

³ Ibid. page K-18.

⁴ TEP's application, pages 1-2.

⁵ Ibid. page 4.

on June 13, 2013.⁶ TEP has never failed to make required payments under the Credit Agreement⁷; hence it has not had the obligation to make payments on the mortgage bonds.

Subsequent Amendments or Refinancings

TEP requests authority to enter into amendments or refinancings over the course of the next three years to extend the term of the new credit agreement. Decision No. 66174 granted similar authority differing in that the period in which TEP could refinance was a period of two years.

The Applicant cites that when market conditions are advantageous there may be opportunities to obtain better terms by amending or refinancing the entire agreement. In order for TEP to take advantage of such opportunities in a timely manner, it needs Commission authorization to refinance or amend its credit agreement in the future.

TEP suggests the following restrictions to future refinancing transactions: (1) limit the authority to amend or refinance its new credit agreement to a period of three years, after which the Applicant must return to the Commission if it desires to renew the authorization, (2) the Applicant's ratings of senior secured mortgage bonds must not decrease from its current investment grade and (3) the Applicant cannot exceed the aggregate amount of the new credit agreement. In addition TEP suggests that it would make a compliance filing with the Commission, within 90 days of entering into an amendment or refinancing to the new credit agreement, certifying that the restrictions described above have been complied with. Furthermore, TEP would explain the business rationale for such amendment or refinancing, inclusive of a demonstration showing that the rates and terms received by TEP were fair and reasonable under current market conditions.

Financial Analysis

Staff's analysis is illustrated on Schedule PMC-1. Column [A] reflects TEP's historical financial information for the year ended December 31, 2005. As of December 31, 2005, TEP had no outstanding borrowings under its revolving credit facility.⁸ Column [B] presents pro forma financial information that modifies Column [A] to include the effect of a one-year \$150 million balloon payment loan at a 6.25 percent⁹. Treating the revolving credit facility as a one-year balloon loan provides a good stress test of the Applicant's debt payment capacity.¹⁰

⁶ Response to data request PMC 2.2.

⁷ Response to data request PMC 3.1.

⁸ TEP's annual report for the fiscal year ended December 31, 2005, page K-54.

⁹ LIBOR plus 0.875 percent. As of September 28, 2006 LIBOR was at 5.37 percent (Value Line investment survey Selection and Opinion, dated October 6, 2006, page 903).

¹⁰ TEP generates operating cash flows in excess of \$240 million, which allow TEP to repay its revolving credit facility balance in full.

TIER, DSC, CCR and Leverage Test Ratio

Times interest earned ratio ("TIER") represents the number of times earnings cover interest expense on short-term and long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not mean that debt obligations cannot be met in the short term.

Debt service coverage ratio ("DSC") represents the number of times internally generated cash will cover required principal and interest payments on short-term and long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations. A DSC less than 1.0 means that debt service obligations cannot be met by cash generated from operations and that another source of funds is needed to avoid default.

Cash Coverage Ratio ("CCR") represents the number of times internally generated cash covers required interest payments on short-term and long-term debt. A CCR greater than 1.0 means that operating cash flow is greater than interest expense.

The 2005 Credit Agreement has two financial covenants. First, TEP is to achieve a minimum CCR of 2.25. Second, TEP is not to exceed a leverage test ratio of 4.50 on the year 2006, 4.25 on the year 2007 and 4.00 on and after the year 2008. The leverage test ratio represents the total indebtedness to earnings before interest, taxes, depreciation and amortization for a 12-month period. The Applicant states that for the quarter ended March 31, 2006, TEP's leverage test ratio was 3.35.¹¹

Schedule PMC-1, Column [A] shows that for the fiscal year ending December 31, 2005, TEP had a 1.43 TIER, a 2.03 DSC, a 2.65 CCR and a 4.14 leverage test ratio before recognition of any additional debt.

The pro forma TIER, DSC, CCR and leverage ratio for TEP under the scenario described above for Column [B] are 1.34, 1.08, 2.49 and 4.55, respectively. The pro forma DSC results indicate that TEP would be able to meet all obligations under this stringent test with cash generated from operations. Conversely, the pro forma leverage test ratio indicates that TEP would not comply with its Leverage Test Ratio covenant in the year 2007. TEP will need to increase its income, reduce its debt or renegotiate the maximum leverage ratio to comply with this covenant.

Capital Structure

At December 31, 2005, TEP's capital structure consisted of 2.3 percent short-term debt, 71.0 percent long-term debt, and 26.7 percent equity (Schedule PMC-1, Column [A]). The scenario described above for Column [B] would result in a capital structure composed of 8.9 percent short-term debt, 66.2 percent long-term debt and 24.9 percent equity.

¹¹ Response to data request PMC 1.6.

TEP has increased the percentage of equity in its capital structure from 16.7 percent to 26.7 percent in the 24-month period ending December 31, 2005.

Compliance

There are no compliance issues with Tucson Electric Power Company.

Conclusion and Recommendations

Staff concludes that the proposed financing (including an increase in mortgage bonds) for the purposes stated in the application is within TEP's corporate powers, is compatible with the public interest, consistent with sound financial practices and will not impair its ability to provide services.

Staff recommends that the Commission authorize TEP's request to increase the amount of the revolving credit facility from \$60 million to \$150 million.

Staff further recommends that the Commission authorize the Applicant to refinance the credit facilities during the subsequent three-year period, should favorable opportunities arise, subject to TEP's suggested restrictions as described in this report.

Staff recommends authorizing TEP to engage in any transactions and to execute any documents necessary to effectuate the authorizations granted.

Staff further recommends that one copy of the executed loan documents be filed with Docket Control within 60 days of execution.

Tucson Electric Power Company
Docket No. E-01933A-06-0345
Application For Financing

FINANCIAL ANALYSIS

Selected Financial Information

		[A] <u>12/31/2005</u>		[B] <u>Pro Forma</u>	
1	Operating Income	\$	165,434,000	\$	165,434,000
2	Depreciation & Amortization		171,122,000		171,122,000
3	Income Tax Expense		33,907,000		33,907,000
4					
5	Interest Expense		139,606,000		148,973,500
6	Repayment of Principal		43,183,520		193,183,520
7					
8					
9	TIER				
10	[1+3] ÷ [5]		1.43		1.34
11	DSC				
12	[1+2+3] ÷ [5+6]		2.03		1.08
13	Cash Coverage Ratio				
14	[1+2+3] ÷ [5]		2.65		2.49
15	Leverage Ratio				
16	[18+20] ÷ [1+2+3]		4.14		4.55
17					
18	Short-term Debt		48,718,000	2.3%	\$198,718,000 8.9%
19					
20	Long-term Debt		\$1,486,469,000	71.0%	\$1,486,469,000 66.2%
21					
22	Common Equity		\$558,646,000	26.7%	\$558,646,000 24.9%
23					
24	Total Capital		\$2,093,833,000	100.0%	\$2,243,833,000 100.0%

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26 [A]: Based on 2005 financial statements.

27 [B]: Column [A] recognizes a one-year, \$150 million balloon loan.

28

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER – Chairman
 WILLIAM A. MUNDELL
 MIKE GLEASON
 KRISTIN K. MAYES
 BARRY WONG

2006 OCT -6 P 1:29

AZ CORP COMMISSION
 DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION) DOCKET NO. E-01933A-06-0345
 OF TUCSON ELECTRIC POWER COMPANY)
 FOR A FINANCING ORDER AUTHORIZING)
 AMENDMENTS TO OR REFINANCING OF ITS)
 CREDIT AGREEMENT)

Tucson Electric Power Company, through its undersigned counsel, hereby submits the
 attached affidavits of publication.

RESPECTFULLY SUBMITTED this 6th day of October 2006.

TUCSON ELECTRIC POWER COMPANY

By



Michelle Livengood
 One South Church Avenue
 P.O. Box 711
 Tucson, Arizona 85702

and

Michael W. Patten
 ROSKA DEWULF & PATTEN, PLC.
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 Phoenix, Arizona 85004

Attorneys for Tucson Electric Power Company

Original and thirteen copies of the foregoing
 filed this 6th day of October, 2006, with:

Docket Control
 ARIZONA CORPORATION COMMISSION
 1200 West Washington Street
 Phoenix, Arizona 85007

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OCT 06 2006

AZ CORP COMM
 Director Utilities

1 Copy of the foregoing hand-delivered
2 this 6th day of October, 2006, to:

3 Chairman Jeff Hatch-Miller
4 Arizona Corporation Commission
5 1200 West Washington Street
6 Phoenix, Arizona 85007

7 Commissioner William A. Mundell
8 Arizona Corporation Commission
9 1200 West Washington Street
10 Phoenix, Arizona 85007

11 Commissioner Mike Gleason
12 Arizona Corporation Commission
13 1200 West Washington Street
14 Phoenix, Arizona 85007

15 Commissioner Kristen K. Mayes
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19 Commissioner Barry Wong
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Director, Utilities Division
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25
26 By 
27

AFFIDAVIT OF PUBLICATION

STATE OF ARIZONA)
) ss.
COUNTY OF PIMA)

Audrey Smith, being first duly sworn, deposes and says that (s)he is the **Legal Advertising Manager** of **THE DAILY TERRITORIAL**, a daily newspaper printed and published in the County of Pima, State of Arizona, and of general circulation in the City of Tucson, County of Pima, State of Arizona and elsewhere, and the hereto attached:

PUBLIC NOTICE OF AN APPLICATION BY
TUCSON ELECTRIC POWER COMPANY
FOR A FINANCING ORDER AUTHORIZING
AMENDMENTS TO OR REFINANCING OF
ITS CREDIT AGREEMENT

was printed and published correctly in the regular and entire issue of said **THE DAILY TERRITORIAL** for 1 issues; that was first made on the 18th day of July 2006 and the last publication thereof was made on the 18th day of July 2006 ; that said publication was made on each of the following dates, to-wit:

07/18/06

at the Request of: Tucson Electric Power

by *Audrey Smith*, Legal Advertising Manager
Subscribed and sworn to before me this 18th day of July 2006 .



JAMIE C. MACIAS
Notary Public - Arizona
Pima County
Expires 02/04/08

Jamie C. Macias
Notary Public in and for the County of Pima, State of Arizona

My commission expires: 2-4-08

PUBLIC NOTICE OF AN APPLICATION BY TUCSON ELECTRIC POWER COMPANY FOR A FINANCING ORDER AUTHORIZING AMENDMENTS TO OR REFINANCING OF ITS CREDIT AGREEMENT

On May 25, 2006, Tucson Electric Power Company ("Applicant") filed an Application with the Arizona Corporation Commission ("Commission") for an order authorizing Applicant to (1) extend the maturity of its \$60 million Revolving Credit Facility and \$341 million Letter of Credit Facility; (2) increase the amount of the Revolving Credit Facility from \$60 million to \$150 million; and (3) enter into similar amendments or refinancings to extend the Credit Facilities during the subsequent three-year period, should favorable opportunities arise. The Application is available for inspection during regular business hours at the offices of the Commission in Phoenix, at 1200 West Washington Street, Phoenix, Arizona, and at the office of the Company, Tucson Electric Power Company, One South Church, Tucson, Arizona 85701.

Intervention in the proceeding on this matter shall be permitted to any person entitled by law to intervene and having a direct and substantial interest in the matter. The granting of motions to intervene shall be governed by A.A.C.R14-3-105. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon Applicant and its counsel and to all parties of record, and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding (e.g., a customer of the Applicants, a shareholder of the Applicants, etc.).
3. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant, its counsel and all parties of record.

The granting of intervention, among other things, entitles a party to present sworn evidence at hearing and to cross-examine other witnesses. However, failure to intervene will not preclude any person from appearing at the hearing and making a statement on such person's own behalf.

The Commission does not discriminate on the basis of disability in admission to its public meetings. Persons with a disability may request a reasonable accommodation such as a sign language interpreter, as well as request this document in an alternative format, by contacting Linda Hogan, ADA Coordinator, voice phone number 602/542-3931, E-mail lhogan@azcc.gov. Requests should be made as early as possible to allow time to arrange the accommodation.

STAR PUBLISHING COMPANY

Tucson, Arizona

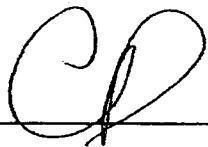
STATE OF ARIZONA)
COUNTY OF PIMA)

Cezar Duron, being first duly sworn deposes and says:
that he is the Legal Advertising Representative of the
STAR PUBLISHING COMPANY, a corporation
organized and existing under the laws of the State of
Arizona, and that the said **STAR PUBLISHING
COMPANY** prints and publishes the Arizona Daily Star,
a daily newspaper printed and published in the City of
Tucson, Pima County, State of Arizona, and having a
general circulation in said City, County, State and
elsewhere, and that the attached

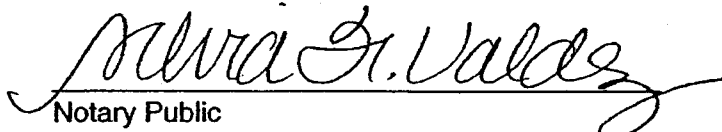
Legal Notice

was printed and published correctly in the entire issue
of the said The Arizona Daily Star on each of the
following dates, to-wit:

July 19, 2006



Subscribed and sworn to before me this 20 day of
July, 2006


Notary Public



SILVIA H VALDEZ
Notary Public - Arizona
Pima County
Expires 12/15/09

My commission expires _____

TNI AD NO. 4923350

PUBLIC NOTICE OF AN APPLICATION BY TUCSON ELECTRIC POWER COMPANY FOR A FINANCING ORDER AUTHORIZING AMENDMENTS TO OR REFINANCING OF ITS CREDIT AGREEMENT

On May 25, 2006, Tucson Electric Power Company ("Applicant") filed an Application with the Arizona Corporation Commission ("Commission") for an order authorizing Applicant to (1) extend the maturity of its \$60 million Revolving Credit Facility and \$341 million Letter of Credit Facility; (2) increase the amount of the Revolving Credit Facility from \$60 million to \$150 million; and (3) enter into similar amendments or refinancings to extend the Credit Facilities during the subsequent three-year period, should favorable opportunities arise. The Application is available for inspection during regular business hours at the offices of the Commission in Phoenix, at 1200 West Washington Street, Phoenix, Arizona, and at the office of the Company, Tucson Electric Power Company, One South Church, Tucson, Arizona 85701.

Intervention in the proceeding on this matter shall be permitted to any person entitled by law to intervene and having a direct and substantial interest in the matter. The granting of motions to intervene shall be governed by A.A.C.R14-3-105. Persons desiring to intervene must file a Motion to Intervene with the Commission which must be served upon Applicant and its counsel and to all parties of record, and which, at a minimum, shall contain the following information:

1. The name, address and telephone number of the proposed intervenor and of any person upon whom service of documents is to be made if different than the intervenor.
2. A short statement of the proposed intervenor's interest in the proceeding (e.g., a customer of the Applicants, a shareholder of the Applicants, etc.).
3. A statement certifying that a copy of the Motion to Intervene has been mailed to Applicant, its counsel and all parties of record.

The granting of intervention, among other things, entitles a party to present sworn evidence at hearing and to cross-examine other witnesses. However, failure to intervene will not preclude any person from appearing at the hearing and making a statement on such person's own behalf.

The Commission does not discriminate on the basis of disability in admission to its public meetings. Persons with a disability may request a reasonable accommodation such as a sign language interpreter, as well as request this document in an alternative format, by contacting Linda Hogan, ADA Coordinator, voice phone number 602/542-3931, E-mail lhogan@azcc.gov. Requests should be made as early as possible to allow time to arrange the accommodation.